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Principles of Corporate Governance with an Application to the Financial Sector

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I. INTRODUCTION

For the last several years the issue of corporate governance (= the problem of the design of performing decision structures at the top of firms) has been heavily debated in Belgium and in most other European countries. Everywhere, these discussions focus on the question whether or not the country's current governance model should be left or adjusted in favour of the US (Anglo-Saxon) approach to the subject. Ever since the acquisition of the Generale Maatschappij by the French holding group Compagnie de Suez, the take over of large domestic firms by foreign companies has been a bone of contention in Belgium. Also the fact that few Belgian companies have been able to grow into large multinational firms has fuelled the discussion about the Belgian governance system.

The current governance debate concerns the relationships between share holders, board of directors and management in publicly quoted firms. At least at first sight, the structures that govern these relationships are remarkably similar between US and Belgian firms. In both countries the duties of the general meeting of share holders consist of yearly returning issues like approval of the annual accounts, as well as exceptional decisions like approval of adjustments in the corporate charter. Next to the possibility to vote, share holders also have the right to receive dividends. In both countries the general meeting appoints the board of directors that in turn hires and fires management.

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Notwithstanding preceding similarities, these structures actually seem to function in a very different way. Particularly, in the US share ownership in publicly quoted firms tends to be relatively dispersed and management holds a very powerful position vis-à-vis the board of directors. In particular, the board consists of both inside directors (= representatives of management) and outsiders (= have no link with the firm nor its management and usually do not represent large share holders) and its role is mainly confined to monitoring management. However in practice management often exercises considerable influence on the board. In terms of balances of power, the Belgian situation is quite different. Ownership is concentrated and, next to reserving some seats for the management team, usually the dominant owners distribute board seats among themselves according to ownership proportions. Directors that are independent of management and large owners play a minor role. As these latter equity holders dominate the board, they actually hire and fire the management and strongly influence the firm's strategic choices. Although their influence has been shrinking over the last decade, a class of large owners that still plays an important role in corporate control are holding groups. However as large holding groups typically exercise control over several (many) firms, in a publicly quoted subsidiary conflicts of interest may easily arise between the parent and the small share holders. For the former wishes to further the interests of the group as a whole while the latter prefer that the company in which they have invested thrives. This is very different from the US where holding firms virtually are non existent.

The main theme of this paper concerns a discussion of the Anglo-Saxon governance system in comparison with Belgian governance from the perspective of transaction cost economics. In the wake of the pioneering work of Williamson ((1984), (1985)) this approach has been very successful in illuminating many difficult governance problems and in pinpointing the role of important governance devices like the board of directors. It also allows for a clear analysis of the famous and competing share holder and stake holder models. This is very useful, especially in Europe where countries are still struggling with moulding or remoulding corporate governance structures, and where the advantages and disadvantages of both latter models continue to be a matter of debate. Furthermore it will be claimed that in the wake of the continuing integration of European stock markets (some) convergence of the Belgian system to more Anglo-Saxon governance habits will be unavoidable. Given this adjustment, the question then arises to what extend these changes in governance may affect financial markets and hence the business of the (Belgian) financial firms. A second and related theme of the paper is the interaction between regulation and corporate governance in the financial sector. In particular, both regulation and governance are concerned with resolving problems of conflicts of interest. Hence, the question whether the analysis of governance problems could lead to useful insights for regulation. It will be seen that when applied to specific regulatory issues it indeed adds useful perspectives.

Section II of the paper describes the development of the share holder and stake holder models. Section III respectively IV discuss the logic of the US (Anglo-Saxon) and Belgian (European) governance models. Next, section V considers the reasons why the Anglo-Saxon model is so influential in the European governance discussion. Section VI contains some remarks on the question whether or not corporate governance will transform the Belgian (European) financial sector. Section VII considers two specific regulatory issues and discusses additional perspectives from the governance analysis. Finally section VIII offers some concluding remarks.

II. GOVERNANCE MODELS: THEORY

Theoretical models of corporate governance are concerned with the design of efficient decision structures at the top of firms. These decision structures comprise the relationships between share holders, managers and other important parties that are involved with the firm (employees, suppliers, customers), ... As the issue at hand essentially is an organisational problem, the first approach would be to set up well balanced organisational structures. Such structures should possess properties like separation of roles to create checks and balances, a clear set of rules of conduct, checks that these rules are obeyed and overall transparency. However applying these ideas is not so obvious in the case of corporate governance. In particular from an organisational perspective there exists an important difference between the top of the firm and all hierarchical layers below. Specifically, all members in lower layers have a 'boss' who serves his/her own interests by keeping a check on his/her subordinates. This is not the case for the top level, and, as will be seenbelow, organising checks and balances with respect to this layer is very difficult. In fact this latter problem is the core issue of the governance discussions all over the world. As it wil turn out, no ready made solutions exist and that any choice has both advantages and disadvantages. Quite a number of issues have to be tackled. For example, if there are many different share holders, as is typically the case in publicly quoted firms, important questions arise about how the relationship between the owners and the management should be organised. Should it be through a special body and if so what should be its tasks? And how should the relationship between employees management and share holders be set up in the structure? Two different models, the share holder and the stake holder model provide an answer to a number of important questions. In particular both models imply that there should be a body like the board of directors to organise the relationship between share holders and management. However they differ in the role that they assign to this board. Both models are discussed in section II.A. Unfortunately notwithstanding the illuminating insights they offer, these models leave important questions unanswered. This issue is discussed in section II.B.

A. *Share holder versus stake holder model*

The share holder model starts from the problems share holders face once management and ownership are at least partially separated, as is the case in many large firms in practice. In particular, because of its involvement with daily operations, management acquires an informational advantage relative to equity owners. This creates opportunities for the former to choose corporate policies that best serves its own goals rather than policies that are best for the firm or the share holders[1]. Contrary to what is often intuitively thought shares are not a strong but rather a weak type of security. This weakness is caused by the residual character of the cash flows of equity. In particular capital is only repaid after all other claimants have received their due. Contrary to debt, there is neither periodic review or maturity of the contract nor any fixed interest payment. Furthermore, once owners have handed over their capital input they are not needed anymore to keep the production process going. This is far less the case for other factors of production like labour. However, just because of its flexible character, companies can hardly survive without equity. These special properties also make it hard to protect share capital from self interested actions of management by simple contracts. Hence a stronger instrument that matches the flexibility of share capital is needed.

This instrument is the board of directors and according to the share holder model the protection of equity holders is the only reason and simultaneously the explanation for the observed existence of boards. Other factors of production are 'stronger' and/or have very specific problems and can therefore be protected sufficiently by other means like contracts (e.g. debt) or special purpose governance mechanisms (e.g. collective wage negotiations, work councils,...). That is, a board is a general governance instrument and it is not cost efficient to use it where a special purpose governance technology would do. Such a loss of efficiency can be easily illustrated by the following case. Imagine for a moment that next to its share holders, some firm would also have debt holders, labour,.... represented on its board. It is not hard to imagine how in such a situation decision making could easily be hampered by continuous negotiations between different parties on the board. On top, ultimate choices would be determined by the at times haphazard way in which majorities are attached through the formation of specific coalitions. In fact it is well known from the literature on voting that if preferences across classes of voters are different, even the order in which problems are placed on the agenda may strongly affect decision making. Hence, according to the share holder model, next to representatives of the management team who are needed for the information flow, one should find only representatives of the equity owners.

Stake holder and share holder model only differ on the issue of board representation. In particular, the stake holder model posits that next to share holders also other parties make residual firm specific investments. In fact any one who has made such type of an input is a stake holder. Often cited examples are the effort spent on building up company specific human capital or the investment sunk in a production process tailored to the need of an important industrial client. Likewise equity such an input is also residual in nature. Hence board representation is the appropriate instrument to protect it. The proponents of this model do not offer a solution to the earlier described negotiation problems. Obviously these difficulties burden the practical application of this view. Another element that hampers the use of this model is confidentiality. In particular, some decisions like strategic choices require confidentiality for success. However, it is clear that board members may serve the class they represent best by not keeping to secrecy. For example, it is easy to imagine that such a problem may occur for labour representatives during merger talks where plans involve a downsizing of the number of employees. Hence if a governance model is to function in practice, either it should keep close enough to the share holder model or the firm should be in a specific situation where it can circumvent the problems associated with the stake holder view.

B. *Theoretical governance models offer an incomplete solution*

It is clear that the logic of the preceding models does not offer a complete solution to the governance problem. For, who assures that the board of directors will actually take up its tasks as it should? Experience shows that it is not enough to prescribe by law that the directors should diligently perform their duties. To guarantee board performance one could think of creating some supervisory body that supervises the board. However in turn, who will guarantee that this monitor of the board will fulfil its duties? This problem of who monitors the monitor is hard to solve. The US governance model discussed below addresses the issue by creating a system of checks and balances (or countervailing forces). In particular, if one can find a party that serves its own self interest by actively keeping the board and hence also the management on its toes, market forces will take care of the monitoring-of-the-monitor-problem. In the pre-1990 governance model of the US, this was the threat of a take-over. In the post-1990 period the countervailing force is share holder activism. Logic and the US experience indicate that the success of a governance model heavily depends on the quality of the pressure and monitoring exercised by this countervailing force. The current critique on the quality of the Belgian governance system (discussed below) can also be regarded as an illustration of the preceding statement. In particular, in Belgium the role of countervailing force has traditionally been played by large dominating share holders. The main issue in the current governance debate is not that these owners have exercised insufficient pressure but rather that they have exercised too much of it. Specificaly, as indicated in the introduction, because control benefits are only reaped by the large owners, the interests of large and small share holders need not coincide. The in the press heavily discussed case of the Belgian electricity provider Tractebel that is controlled by its French competitor Suez-Lyonnaise des Eaux clearly illustrates the problem at hand. Hence the in Belgium still ongoing quest for a countervailing force to keep the large owners in check in publicly quoted firms. In short, the preceding discussion shows that because corporate governance is concerned with the top layer in the hierarchy of a firm a solution has to be found for the absence of a 'boss'. What is needed is a force that actively 'monitors the monitor'.

III. GOVERNANCE MODELS IN PRACTICE: THE US (ANGLO-SAXON) CASE[2]

The main task of US boards is monitoring management in the interests of equity owners. This objective translates itself into the pursuit of the creation of value for the owners. Hence in this environment the fast rising popularity of a system like Economic Value Added (EVA) that aims at maximising share holder value, should not come as a surprise. The interests of other parties like workers, debt holders, customers... come into the picture mainly as constraints on managerial decision making. In the US the view that share capital is vulnerable and should be protected is part of a long standing tradition. In contrast to Europe, where over the past century substantial efforts have been devoted to the protection of labour, in the US considerable attention has been paid to the protection of small share holders. As explained in the introduction, US boards typically consist of inside directors - members of management - and outsiders - directors independent of management and usually also of share holders. The fact that outside directors often do not represent large share holders is obviously a consequence of the dispersed ownership structure of many publicly quoted firms. In practice this ownership structure has proven to entail important disadvantages. In particular, at least until the recent past, due to the free rider problem of dispersed ownership, it was not unusual that management had attracted sufficient clout to determined board membership[3]. Obviously under such circumstances one would not expect much board independence and strong monitoring. Nevertheless this latter type of activity is important. For one has observed in the US that in the absence of sufficient monitoring management slack grows as well as the tendency of firms to over invest in often wasteful projects. The by now classical example illustrating this phenomenon is the growth of the US conglomerates during the sixties. Also the royal compensation packages that management receives - sometimes resulting in yearly incomes of over $ 100 million US - is likely associated with management clout. However as discussed below the last several years the US corporate governance scene has witnessed important changes.

A. *US governance closely adheres to the logic of organisational theory*

Traditionally US governance is based on three principles that reinforce each other: transparency, checks and balances and the radical treatment of conflicts of interest. In fact in many respects the US governance system applies the textbook principles of organisational theory. For prime elements of a sound organisational structure are transparency, clear separation of functions and ditto behavioural rules, this in order to create checks and balances. Also structures that foster infighting and hence conflicts of interest are avoided. Until the recent past the functioning of the checks and balances proved to be the system's main weakness. Not surprisingly, the main theme of the US governance debate of the late eighties and early nineties has focused on this problem.

Element 1: transparency

A first tool that helps transparency is provision of information. Consistent with the earlier mentioned long time goal of small share holder protection, at least to European norms, publicly quoted firms have to provide investors with detailed information since many years. Thereby the equal treatment of all share holders has been a major concern to regulators. To illustrate the difference with the Belgian tradition it suffices to refer to the law prohibiting insider trading, enacted in Belgium in 1990 but inspired by long-standing regulation in the US. A second element that supports transparency is a clear set of professional behavioural norms and separation of functions with respect to the different governance parties. In particular, in the US management's task is to enact and oversee daily operations as well as designing corporate strategy. The board serves as 'first-line' monitor and decides about whether or not to approve management's strategy proposals. Finally the financial markets provide financing and engage in permanent 'second line'-monitoring aimed at keeping both management and board on its toes. As discussed below, in the pre-1990 area this 'second-line' monitoring proved to be mediocre which in turn caused 'first-line' monitoring to loose quality. Because of their key role since the early nineties much attention has been devoted to develop rules for the functioning of boards and to support the independence of independent directors. For example, currently it is considered good governance practice if the majority of the board consists of independent directors, chosen on the basis of clear professional criteria. It is equally considered good practice if, within the board, committees specialising in key issues and dominated by independent directors are created. Examples of key issues are auditing, remuneration of top executives and hiring and firing of independent directors. Realists however understand that preceding precautions help but still cannot guarantee that the independent directors remain independent and function as the monitor of the monitor. For why should an independent director spend effort on checking the propositions of management, especially as the latter is better informed anyway? Clearly the problem of 'who-monitors-the-monitor' is hard to solve. Current US-governance practice has found a solution in strengthening checks and balances by spurring share holder activism.

Element 2: checks and balances

In the US (Anglo-Saxon world), institutional investors as a group own an important fraction of the shares quoted on the national stock market(s). Their importance derives from the pension system that is based on the principle of capitalisation. Contrary to the model of repartition (as is used in Belgium) whereby those currently working pay for those currently retired, the principle of capitalisation presumes that those currently working save for their own pensions. In this way under the latter system, in a wealthy economy vast reserves are formed that need to be invested. In the US system these reserves are concentrated in the hands of pension funds managed by professional money-managers. Consequently, currently more than 50% of all publicly traded shares in the US are owned by institutional investors.

Since the early nineties these latter owners are strongly stimulated to take up a more active role in questioning company management and boards. In fact as of the late eighties the US governance system has been steering away from hostile take-over bids (or the threat of it) as the countervailing force to keep managements and boards on their toes. During the eighties this method - which essentially involves a one shot activation of ownership (through the intermediation of the raider) - had come increasingly under attack. First of all this route of removing slack management is very costly as it typically involves payment of substantial premia to the target share holders. Hence it is only usable for more extreme cases of under performance. Secondly, and even more dissatisfactory, in practice it turned out that those firms that needed disciplining most, usually were not the targets of the raiders (see e.g. Franks and Mayer (1992)).

Since the late eighties US governance has gradually been adjusting to a new model whereby permanent activation of share ownership takes a more prominent role. In particular, over the last several years US courts have increasingly upheld corporate defences against raiders. Simultaneously institutional investors have been forced to take a more active owner ship role by obliging them to vote at the general meeting of the companies in which they invest. This obligation has even been extended to investments abroad. However the role of active share holder does not imply that institutional investors should strive for exercising control over firms. In fact the latter is disallowed and institutional investors may not even accept board seats. This attitude of US regulators clearly reflects the textbook view of organisational theory that the most appropriate way to create checks and balances is through separation of roles.

Over the last several years, institutional investors have indeed been more active in monitoring firms. In fact it should be easier to stimulate activism with institutional investors as compared to small share holders. For one thing, professional money managers should be able to do a better job at monitoring than non-professionals-small-owners. Furthermore the earlier mentioned free rider problem can more easily be overcome as the ownership of institutional investors is large enough for value gains from activism to compensate for the monitoring costs. In practice many institutional investors have actually changed their behaviour. Instead of applying the traditional wall street rule (= sell if you do not like the management) they have moved towards taking a more active stance. Some have even become renowed for their activism. For example, California Public Employees Retirement System (CALPERS) and the California State Teachers Retirement System (CALSTRS) are reputed pension funds that publish black lists of firms with lackluster performance. Often share prices already improve immediately upon publication as the stock market anticipates that, under the pressure of these funds' monitoring actions, positive changes will take place within the firm. Notwithstanding all the media attention, empirical evidence indicates only a limited long term direct impact of institutional activism however. In particular, the data show little evidence of improvement in long term market performance after the targeting, and if a change in the real activities of the firm is perceived, it is hard to establish the causal relationship between activism and the change (see e.g. Gillan and Starks (1998)).

Next to institutionals, also some share holders have become more active under the influence of bulldog-firms. The latter are specialised lawyer companies that search for opportunities to initiate a court case and then attempt to receive a mandate from share holders to sue management and/or the board. Obviously, these bulldogs function as a mechanism that overcomes the free rider problem which is a plus. However one may expect its monitoring impact to be of lesser quality than that of institutionals. In fact, bulldogs may create a problem of their own because, typically these firms are paid only if a court case is won. Hence, these firms do not aim at separating out good from mediocre corporate decision making. Rather they are interested in finding decisions that can be represented in such a way that a possibly winning court case can be constructed. The averse effects of this type of monitoring can be illustrated by the problems in the field of medical treatment. In particular, it is not unusual in the US that doctors refuse to treat badly ill patients because they anticipate to be sued if the treatment does not lead to a cure.

Element 3: preventing conflicts of interest between share holders

Likewise the protection of small owners, the reduction of conflicts of interest between share holders has been a long time goal in the US system. Already since the thirties, the legal and fiscal environment is hostile to the formation of large holding groups with publicly quoted subsidiaries. The tax treatment of complex holding structures is unfriendly, and also the antitrust regulation has hampered the formation of complicated ownership structures that often are so important in European countries. Next to reducing potential conflicts of interest, strict rules have been laid down for the handling of remaining problems. For example, the fact that all relationships between a publicly quoted subsidiary and parent firm have to be at-arm's-length (i.e. be commensurate with market conditions) has a long standing tradition in practice. By contrast, the at-arm's length-tradition in Europe is still evolving. Also, in the US, in order to obtain a quotation on the stock exchange, a company has to prove that in case conflicts of interest between share holders could occur, mechanisms are in place to control these problems. Certainly in the US governance system of today, avoidance of conflicts of interest is important because of the role of monitor of the monitor played by some classes of share holders. Clearly this monitoting activity may quickly loose quality if it gets polluted by class-specific goals.

B. *No solution is perfect*

As mentioned before, solving the problem of who monitors the monitor is extremely hard and it is unlikely that a perfect solution exists. Clearly the choice of the US is driven by the opportunities available in its financial mass markets of today. Notwithstanding its logic, the system nevertheless has inherent weaknesses. First of all, the risk of an overly powerful management continues to loom around the corner. Secondly, asymmetries in information that are necessarily present in mass markets and the strong dependence on the quality of the judgement of outsiders may force decision makers to opt for well accepted recipes even if a less traditional solution would be more appropriate. Therefore successful communication with the market has taken up a key role and firms have been adjusting to cope. To quote Ettorre (1996), 'Fifteen years ago, the CEO and CFO did not know major share holders and really didn't care. CEO's are now more accessible to money managers'. A third and closely related problem concerns the often heard complaint about the fact that adherence on the judgement of outsiders would force companies to realise profits in the short run. Especially the mandatory reporting of quarterly profits attracts much criticism. It goes without saying that this latter obligation forces management to spend (too?) much effort on maintaining a smooth profit flow. Doubtless this will sometimes also lead to situations where, at least from the perspective of their inside knowledge, management feels obliged to take sub-optimal decisions. However the positive impact of the monitoring by active share holders should not be under rated: as discussed aboves, an active 'monitor of the monitor' is crucial in maintaining the quality of the governance system in publicly quoted firms.

IV. GOVERNANCE MODELS IN PRACTICE: THE BELGIAN CASE

As indicated in the introduction, the governance situation in Belgium as well as in most other continental European countries is quite different from the one in the Anglo-Saxon world. The most striking difference probably is the concentration of ownership. Although also in the US publicly quoted companies may have large or even majority owners, overall the ownership is much more dispersed there. Notwithstanding the overall picture of stronger concentration of ownership, still important differences between European countries may exist. In particular comparative evidence indicates that the percentage of publicly quoted firms controlled by a large share holder or syndicate of large equity holders is higher in Belgium than in its neighbouring countries (Wymeersch (1997)). Consequently, large share holders typically dominate Belgian boards, and hence also the process of hiring and firing management. Furthermore, as they invest in following up the firm, these owners strengthen their influence even more relative to the passive small owners. In this way - at least as compared to the US where overall there is a clear seperation of rules - in Belgian practice usually there is not such a clear distinction between the roles the different governance actors actually play. Obviously the main advantage of this method of organising top decision making consists of the close attention large share holders pay to what happens in the company. Most importantly, although it is different from the US (Anglo-Saxon) method, the Belgian way of activating share ownership also offers a solution for the difficult problem of who 'monitors the monitor'. However this method of handling the latter issue also raises two important questions. First, are conflicts of interest between share holders resolved (i.e. this is a question about the quality of the monitoring by the monitor of the monitor)? Second, is this type of governance optimal for all firms at all times?

A. *Belgian governance and conflicts of interest*

Notwithstanding multiple attempts to resolve conflicts of interest between classes of share holders, this problem still remains at the heart of the governance discussion in Belgium. An important step in tackling the issue was taken in 1995. Since then corporate law requires that any transaction between a parent and its publicly quoted subsidiary should be evaluated in a report drawn up by an expert and three directors that are independent of both management and share holders (Ralet (1996)). Although such a measure is useful, still it cannot prevent many types of conflicts. A parent that consistently steers business opportunities to other firms of the group is only one possible example. Another one is the case where the company is forced to adjust its strategy to fit its self financing capacity. Furthermore, as discussed in section 2, without checks and balances it is difficult to keep the independent directors independent. Whereas in the US independence with respect to management is the issue, in this case the problem concerns maintaining independence from the large share holders, especially as these owners typically determine board seats. Recently several organisations have come forward with propositions for improvement. The Commissie voor het Bank en Financiewezen suggests rules for more transparency. The commissions Cardon and Santens as well as the VBO focus on the board and propose rules that should lead to improvements in the quality of board functioning. A common feature of the latter reports is that they contain rules aimed at making boards more autonomous relative to large owners. For example, a typical suggestion is that boards should have independent directors; also the creation of specialised committees with an important role for the latter board members is suggested as good governance practice. Clearly these propositions are inspired by US-style governance, but certainly do not go all the way. This is understandable. For the moment experience with a governance system in which independent directors play an important role is lacking. Furthermore as indicated earlier, the US (Anglo-Saxon) evidence shows that the most difficult problem with this type of directors is to keep them independent. Without checks and balances it will be difficult to avoid that over time they become dominated by the large owners. On the other hand, with the more radical solution that requires that independent directors fill the majority of board seats, the problem of dominance by management looms around the corner. Finally, even a well functioning board still cannot resolve all conflicts of interest. For example, one could imagine that at the general meeting, for purposes of serving the interests of the group, a parent firm uses its voting power to block the propositions from the board of a publicly quoted subsidiary.

B. *Is a uniform governance model good?*

A striking feature of current Belgian governance is the almost uniform application of the governance model with dominating share holders. As indicated above, concentrated ownership is the typical method by which in continental European countries (certain classes of) share holders in publicly quoted firms are activated. Preceding discussion certainly does not imply that this type of activation is inferior to the market based activation in the US. What is important is the motivation underlying the choice for concentrated share holder ship. Opportunities to derive important control benefits based on conflicts of interests between owners is a negative reason for concentrated ownership; another negative reason is under developed capital markets. By contrast, a much better motive concerns reaping a sufficient return on managing the firm well (i.e. the case of the manager-owner) or reaping a return on the investment of monitoring management. In fact some firms prove to be better off with concentrated ownership. In particular, numerous US companies with weak growth potential but strong cash flow have realised dramatic improvements in profitability after share holders from the public at large were bought out and hence a more concentrated ownership structure was realised. However after major operational restructuring has taken place, often these firms are taken public and may end up again with (relatively) dispersed ownership. Furthermore although dispersed ownership is an important feature of US governance, large block holders are not unknown in the US. In fact Shleifer and Vishny (1986) mention that some 30% of the Fortune top 500 companies have large owners. However it should be understood that in the US a block of 5 to 10% of the shares represents a very important ownership position. By contrast in Belgium, a block of this size is still considered to be relatively small, and unless a coalition can be formed with the dominating share holders, it may not yield influence over firm decision making. Preceding US-evidence contains a very important suggestion concerning ownership however. In particular, it indicates that it is highly unlikely that in a dynamic economy all publicly quoted firms are at all times best off with concentrated ownership. The observation that in a particular country all firms adhere to this type of owner ship structure should trigger questions about the underlying motives. Although the argument of an undeveloped capital market may have had relevance in the past, it is becoming quickly less satisfactory as an explanation for the currently observed ownership structures in Belgium. Furthermore, and this contains a further negative indication for the Belgian situation, international evidence reported in La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997) indicates that the degree to which publicly quoted firms adhere to concentrated ownership is positively correlated with unresolved conflicts of interest.

V. US (ANGLO-SAXON) GOVERNANCE IS A SUCCESSFUL EXPORT PRODUCT: A RATIONALE

Although the Anglo-Saxon type of governance is dominant only in a small fraction of the financial markets of the world, i.e. in the Anglo-Saxon capital markets (other countries tend to base their governance system on concentrated ownership), this governance model has nevertheless been extremely influential in European governance discussions. In fact for several reasons one may expect that in the future its impact on Europe will continue to rise. In particular, within Euroland, stock markets are quickly integrating so that a financial mass market is likely to emerge within the next few years. In this mass market institutional investors will be important actors and companies will have to adjust to these investors' demands. Thereby the latter typically consider a firm's adherence to the Anglo-Saxon governance rules as a stamp of quality. As in financial mass markets quality labels are important[4], and as Anglo-Saxon rules are suited to be used in mass markets and as on top no alternative quality label is available, one may expect increasing pressure on European countries to move closer towards the Anglo-Saxon model.

Other developments are also likely to force Belgian (European) publicly quoted firms will have to pay more attention to the preferences of the group of non dominant owners. In the future, in particular, the lure of the historically high stock price levels has led an increasing number of firms to undertake an initial public offering or a seasoned offering during the late nineties. In fact, until the recent past very few Belgian (continental European) firms ever considered the idea of getting a public quotation. Moreover once quoted, these companies rarely tapped the stock market for fresh equity capital. This together with a limited free float and hence small liquidity of the market in firms' shares, contributed to the fact that limited attention was paid to the stock market in corporate decision making. Obviously, when raising cash from the public market becomes more important, this necessarily implies that more attention has to be paid to the latter. Another factor that causes a rise in companies tapping the financial resources of the market are new growth opportunities. Whereas in the past most Belgian firms were able to adjust their growth plans to fit self financing, for an increasing number of companies this has become impossible. In particular, contrary to the more traditional businesses where the size of the market is often geographically limited, the high-tech sector is concerned with products whose natural home market reaches far beyond the borders of the country where the firm is located. Furthermore developments in that area often imply that if a company is to prosper it needs to attain quickly a leading position world wide or at least continent wide. Finally, in several business sectors, significant increases in scale through mergers and acquisitions are taking place. Again, the latter type of transactions requires additional financing.

Next to the increased appetite for additional financing, also overall changes in the environment are already today causing (some) companies to change their attitude towards the stock market. First and foremost, with the Euro, the home market for Belgian investors will continue to broaden to encompass Euroland. This implies that the traditional home-bias (i.e. unvestors' preference for securities from the home country) will weaken. One may expect that this tendency to internationalise portfolios will be enhanced by the rising importance of institutional investors. In turn this will force firms to compete internationally for investors' money. In fact the example of Sweden shows that the pressure of institutional investors may quickly force companies to adjust their governance system to a more market oriented view. Even ownership structures have changed over a time span of a few years after Anglo-Saxon pension funds increased their investments in Swedish firms. In particular, Rydqvist and Odegaard (1997) report that the percentage of publicly quoted firms with more or less widely dispersed ownership (i.e. no one owns more than 25% of the shares) increased from 5% to 24% in the period 1991-1996, and this primarily due to a different ownership structure of newly quoted firms. Simultaneously the traditional premium for shares with multiple voting rights vis-à-vis those with single voting rights dwindled to almost zero. A second change in the environment that could deliver an important contribution to firms' preoccupation with the stock market is the increasing interest in and success of stock option plans (in Belgium and Europe). International competition for top talent places especially European high-tech firms under an increasing pressure to match US (Anglo-Saxon) payment conditions. Whereas in the past the legal and fiscal system has been hostile to it, since the mid nineties several European countries (among which Belgium) have been adjusting rules in favour of this type of remuneration, whereas others are working on proposals in that direction.

It is important to note that preceding discussion does not imply that concentrated ownership will disappear in Belgium (Europe). For the problem of European governance is not that large ownership would be a bad thing. In fact, as previously indicated, large share holders may be a plus for the governance system as they help to resolve the problem of 'who monitors the monitor'. Rather the main issue in the European discussion concerns the fact that conflicts of interest have not been sufficiently addressed. And, as mentioned in the previous section, also in the Anglo-Saxon world numerous prospering publicly quoted firms have a large block holder.

VI. WILL CORPORATE GOVERNANCE TRANSFORM THE BELGIAN (EUROPEAN) FINANCIAL SECTOR?

Notwithstanding the fact that European corporate governance is likely to undergo major adjustments in the next few years, one may not expect these changes to transform the Belgian (European) financial sector. Rather the evolution in governance is part of a major process of transformation of financial markets that is generally expected to deeply affect banking firms.

Many articles have already been devoted to the impact of future trends on banking firms[5]. A discussion of these expected changes obviously falls outside the scope of the present paper. Nevertheless a few comments on corporate governance and the transformation of European financial markets are in order here. As discussed in section V, future trends are likely to trigger important adjustments in corporate governance. However, conversely, the earlier mentioned evidence from La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997) also implies that a more market oriented governance model as the one of the US better supports a financial mass market in equity and bonds. Put differently, US-type governance would support desintermediation. For banks this obviously has a negative impact because lending business may be lost. Simultaneously however, desintermediation and a governance model that is more open to outsiders creates more investment banking opportunities for financial intermediaries. Furthermore if the more market oriented governance view spills over into the sector of non quoted firms, the venture capital subsidiaries of banks may also profit from a rise in activity. On the negative side, traditional saving products offered by banks will likely loose interest from the investing public. On the positive side however the changes in the financial markets will create opportunities for new products and more fee business from money-management. Overall at present it is still to early to make predictions about whether advantages will outweigh disadvantages. Furthermore such a prediction exercise is hampered by the fact that not only European banking models differ from country to country, but also that within countries the market position of intermediaires and hence their likely reaction to changes in the environment may differ also.

VII. CORPORATE GOVERNANCE LOGIC AND SPECIFIC REGULATION ISSUES: TWO BELGIAN EXAMPLES

In the introduction the question was asked whether ideas from corporate governance could illuminate or at least offer additional perspectives with respect to specific regulatory issues[6]. This section illustrates that, at least for the problem of bank ownership of share capital in other firms, this is indeed the case. In particular, subsequent subsections VII.A. en VII.B. offer some comments on the issue of permanent ownership of large blocks in publicly quoted firms and the issue of transitory ownership of shares in non quoted companies from the governance perspective.

A. *Large "permanent" owner ship blocks in publicly quoted firms*

Ever since the abolishment of the mixed bank in Belgium in 1935 and the ensuing split of its business into the activity of commercial banks on the one hand and the business of holding firms on the other, at regular intervals there has been an upshot in the debate about whether or not commercial banks should be allowed to take large permanent positions in the ownership of publicly quoted firms. Although over time the original ban on share ownership has been weakened to allow banks to permanently own equity in financial subsidiaries and take transitory ownership positions in the framework of investment banking activities, the general principle still remains that commercial banking and the business of holding firms should be kept separate. In the past the usual arguments in favour of lifting the ban concerned diversification and provision of additional risk capital. In particular, time and again it was argued that publicly quoted Belgian firms had difficulty attracting investors to provide them with sufficient equity financing. Banks could help solving the problem by investing in shares and hence channel more savings towards equity capital. This argument was often complemented with the reasoning that although shares are risky and hence equity investments could increase the risk profile of the bank, such an increase should not be over estimated. Specifically, this type of activity would allow banks more diversification possibilities and hence give them more opportunities to generate income from multiple sources. However today the ??? are likely to outweigh the ???. First there is the longstanding argument rooted in the experience from the economic crises of the thirties where losses on equity positions brought banks into difficulties. Furthermore, with the development of Belgian capital markets, and in view of the impending integration into a large Euro-market, at present as well as in coming years, risk capital is (likely to be) sufficiently available. Finally the arguments from corporate governance given below indicate that in today's capital markets the disadvantages of banks as large block holders probably outweigh the advantages.

According to the academic literature, the main advantages of using banks as large share holders-monitors are threefold. First there is the opportunity to reduce information asymmetries thereby benefiting both banks and borrowing companies. Second, some conflicts of interest may be mitigated when banks also become share holder. Third, large share holders are strong monitors. The hypothesis that information flows between banks and borrowing firms are favourably affected if a banker can simultaneously play the role of lender and share holder is based upon the observation that both lending and monitoring require inside information. Clearly if the banker-large share holder is also represented on the board, it has two channels to receive complementary information. This reduction in information asymmetries is hypothesised to result in many beneficial effects. For example, it is argued that because the banker is better informed, it may be less reluctant to extend loans because it understands that the management lacks the necessary informational advantage to fool the banker. Furthermore since the financial intermediary is both share holder and lender, the conflicts of interest between the providers of those two kinds of financing is reduced (see for example Mülbert (1998)). However, when the firm is publicly quoted these advantages also imply conflicts of interest between the banker and the small share holders. For the intermediary's motives can be regarded as a portfolio of share holder and lender interests in which the weights of the different views vary according to the relative benefits of its ownership stake and lending activities. In fact, the basic argumentation concerning the rationale for a board from section II implies that bringing debt interests onto the board causes governance inefficiencies if taylor-made protective mechanisms for debt are available. In particular to protect itself against unanticipated swings in corporate policy tnat could impede its position, a debt holder can use protective covenants. Furthermore the whole idea of having publicly quoted companies is that there is enough information available to allow share holders from the public to make an assessment of the firm's situation so that the stock price reflects future opportunities in a reasonable way. One would expect that this information also suffices to make reasonable assessments about the quality of a loan. Hence the ultimate remaining advantage of the mixed banking model is the one of the strong monitoring by a large share holder. However from the previous discussion it is obvious that banker-lenders are not the ideal large owners because of conflicts of interest. Furthermore because the business ties between intermediary and firm are close, it is very difficult to avoid these problems. As indicated earlier, the governance discussion in Belgium (and many other European countries) essentially centres on the impact of large share holders on the quality of firm governance. What can be learned from the US governance system of today is that avoidance of conflicts of interest is important once certain classes of share holders fulfil the role of monitor of the monitor. As discussed earlier, the quality of the governance system heavily depends on the quality of monitoring exercised by the latter, and class specific goals may quickly undo beneficial effects.

Finally, next to academic arguments, also more practical oriented reasons in favour of the mixed banking model have been offered. In particular it has sometimes been argued that the banker-share holder could provide firms with financial and fiscal know-how as well as access to business networks. It is unlikely that these arguments have practical relevance though. For, although this may be true for small companies, it is doubtful that publicly quoted firms are insufficiently professionalised so as to be in need of permanent support in these areas.

Mülbert (1998) discusses empirical evidence on Germany where share ownership of banks in publicly quoted firms is important and finds that the results are inconclusive about the benefits of bank block holders. In particular, some studies find that banks do a good job at monitoring industrial firms, while other research indicates that bank interference leads to no better or even inferior results. Especially for later periods, the majority of the studies find average or even inferior performance of banks as large block holders as compared to non bank large block holders. In particular Gorton and Schmid (1996) considered two samples: one for 1974 and another one for 1985. For the first period, company performance was positively related to bank holdings, while for the second period no relationship was found. For a sample comprising the period 1988-1992 Nibler (1995) confirms the results from Gorton and Schmid's 1985 sample and reports that banks do not perform their monitoring task any better than other large share holders. Wenger and Kaserer (1998) find for the period 1974-1993 even a negative relationship between block holding by German banks and company performance. Along the same lines Böhmer (1997) reports that in take-overs bidder share holders realise a smaller return if banks are important owners of the bidding firm.

B. *Transitory financing of non quoted firms by specialised subsidiaries (= captive venture firms)*

From the perspective of governance arguments, the case of banks temporarily owning blocks in non quoted firms is quite different. For the latter type of companies the earlier arguments about information asymmetries and effective support in terms of financial, fiscal, organisational know how and access to networks are much more likely to be of practical significance. Furthermore as these firms are non quoted, the problem of conflicts of interest with small share holders does not exist. What remains however are possible conflicts of interest embedded in risk taking by the bank vis-à-vis its depositors and its other debt holders. Current regulation minimises such conflicts as banks are required to cover investments in shares in full by bank equity. Furthermore as regulation does not permit other equity positions than those in financial subsidiaries and transitory ownership in the framework of investment banking activities, Belgian banks are forced to concentrate venture capital activity in specialised subsidiaries. This latter policy adds to transparency and obviously is a plus from the perspective of good governance.

VIII. CONCLUSION

This paper discusses the logic of the share holder and the stake holder model for corporate governance and the way these theoretical ideas are applied in the actual governance system of the US (Anglo-Saxon) and Belgium (Continental Europe). Several major conclusions follow. First, a good governance solution for publicly quoted firms requires that the problem of 'who monitors the monitor' is addressed. In turn this implies that to be successful, actual governance systems need the integrated use of several tools. Second, because of the importance of quality labels in financial mass markets, and the fact that so far Europe has not been able to build a consensus on a workable alternative, the US (Anglo-Saxon) view of governance is likely to gain influence in European stock markets. Finally, when corporate governance arguments are applied to the problem of share ownership by banks within the Belgian context, it is seen that governance models add useful perspectives to this regulatory issu.

NOTES

1. This agency problem was first analysed by Coase (1937) and by Jensen en Meckling (1976).
2. Section III and IV follow the discussion in Van Hulle (1999).
3. The free rider problem refers to the situation in which no individual small share holder undertakes costly monitoring because the gain this owner reaps on his/her ownership position is too small to offset the costs. Furthermore all share holders participate in the gains and therefore every individual owner waits for somebody else to initiate the monitoring and free ride on the latter's monitoring investment.
4. Two prominent problems in mass markets are information costs and information asymmetries. Quality labels help to reduce these problems and hence help the mass market to remain viable. A prominent example of the use of such labels is debt rating.
5. The terms 'bank', 'financial firm' and 'financial intermediary' will be used interchangeably.
6. For more general discussion about the interaction of governance and bank regulation, see Van Hulle (1999).

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